Spring 2012

Business Law Section Newsletter

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Message From The Chair

Fellow Section Members:

I am excited to announce that Section membership has now grown to exceed 4,000 members. This Spring the Section has been active in planning and presenting business law-oriented CLE seminars. Information about those courses appears in the newsletter. For many of these courses, Section members can register at a discount that pays for the cost of your membership. The Section has also been actively planning its presentations at the upcoming Annual Meeting taking place in Houston during June. If you are in Houston for the Annual Meeting, please consider attending the day-and-a-half of CLE jointly provided by the Business Law Section and the Corporate Counsel Section.

Among some of the other activities of the Section, it has been engaged in the following:

- The Securities Law Committee has welcomed a new Securities Commissioner to Texas and begun working with him and his staff to identify state rules that may be affected the Dodd-Frank or the JOBS Act. As part of that process, the committee has begun to create subcommittees to focus on particular substantive and procedural areas of state law.
- Section members are also actively working to create a Forms and Practice Manual for publication, and the E-Commerce Committee is monitoring ongoing developments in transacting business on the internet
- The Section recently published a new edition of the Texas Journal of Business Law, which reached members in mid-March.

Various committees are monitoring recent court decisions about piercing the corporate veil in limited liability companies.

I hope that you find this Newsletter interesting and useful.

David Harrell, Chair of the Business Law Section, 2011-12

Law of Lawyers Committee Report—Consumer Financial Protection Bureau Demands Access to Privileged Information

By: John Podvin
Partner, Haynes & Boone LLP

The Consumer Financial Protection Bureau (the "***Bureau***") was created under Title X of the Dodd-Frank Act. On January 4, 2012, the Bureau issued CFPB Bulletin 12-01 regarding "The Bureau's Supervision Authority and Treatment of Confidential Supervisory Information" (the "***Bulletin***"). On July 21, 2011, the Bureau assumed the authority to supervise insured depository institutions and credit unions with total assets of more than $10 billion and their affiliates as well as other non-bank providers of consumer financial products and services ("***covered entities***"). As part of it supervisory responsibilities, the Bureau will make a supervisory request of covered entities for certain information, which can include information covered by the attorney-client privilege. (Continued on Page 9)

ACORN Suit Challenging Home Equity Interpretations

By: Mike O'Neal and Alex Vales
Partners, Winstead P.C.

On January 29, 2004, the Association for Community Organizations for Reform Now ("***ACORN***") and six individuals filed suit against the Finance Commission and Credit Union Commission (collectively, the "***Commissions***") in the 126th District Court of Travis County challenging the validity of certain home equity interpretations adopted by the Commissions. The validity was challenged generally as follows: some interpretations are new rules which the Commissions had no authority to enact; or the Commissions exceeded their authority to interpret the Texas Constitution because some interpretations contradict the plain meaning and intent of the constitutional provisions, and some impose additional burdens and restrictions in excess of or in a manner inconsistent with the constitutional provisions.

On April 29, 2006, the trial court granted in part and denied in the part cross‐motions for summary judgment, finding that seven of the nine interpretations challenged by ACORN were invalid. The trial court also issued a stay which effectively prevented any person from enforcing its judgment.

The Commissions, the plaintiffs, and the Texas Bankers Association ("***TBA***"), an intervenor, each filed a Notice of Appeal to challenge the trial court's decision. The Third Court of Appeals adopted the trial court's stay and extended that stay pending disposition of the appeal. While the appeal was pending, the Commissions repealed three of the seven interpretations that had been invalidated by the trial court. The Third Court of Appeals heard oral arguments on January 31, 2007.

On January 8, 2010, the Third Court of Appeals reversed, in part, and rendered judgment upholding three of the four remaining interpretations that had been invalidated by the trial court. The majority affirmed the trial court's holding invalidating the interpretations defining what constitutes "interest" and therefore is excluded from the three‐percent fee cap. The Commissions had defined interest as it had been defined by Texas courts and the Texas Finance Code: "compensation for the use, forbearance, or detention of money." The majority held that interpretation was "extremely broad," "would defeat the purpose of the constitutional provision imposing a fee cap in the first place" and was, therefore, "contrary to the intent and plain meaning of the constitution." Justice Puryear issued a Concurring and Dissenting Opinion stating that he believed that interpretation should likewise be upheld. Justice Puryear noted that "[i]t is hard to imagine a more reasonable manner in which the Commissions could have attempted to give effect . . . than using the very definition" the Legislature had used to define "interest."

The plaintiffs, the Commissions, and the TBA each filed petitions for review in the Texas Supreme Court. The Commissions and the TBA are asking the court to uphold the Commissions' interpretations defining what constitutes "interest," as opposed to "fees" subject to the three‐percent fee cap. The plaintiffs are asking the court to invalidate the Commissions' rules that allow a homeowner to a sign home equity loan documents using a power of attorney and that allow a lender to show that it provided the required disclosures about the terms of a loan through proof that it mailed the disclosure to the homeowner. After the cross-petitions for review were filed, ACORN withdrew from the case.

On February 25, 2011 the Supreme Court of Texas granted the parties' cross petitions for review. Oral argument was heard on September 13, 2011. A webcast is available at: http://stmarytxlaw.mediasite.com/mediasite/Catalog/pages/catalog.aspx?catalogId=c7b36466-40e3-4d88-b90c-0761e609344e. The Supreme Court provided the following summary:

> Among principal issues in this challenge to regulations promulgated for home-equity lending in Texas are (1) whether deference should be the review standard for agency interpretations when the agencies – the Finance Commission and Credit Union Commission – were given power to interpret constitutional home-equity provisions; (2) whether the two commissions erred by adopting the Finance Code's definition of "interest" for interpreting the constitutional provisions; and (3) whether the appeals court erred when it upheld agency rules that allow signing a home-equity loan by power of attorney instead of specific locations set by the home-equity amendment. The trial court invalidated seven of nine challenged regulations. On review, the court of appeals held the standard of review should be the deference given state-agency statutory interpretations. The appeals court affirmed the trial court in part and reversed and rendered judgment in part, holding the commissions' rules defining interest were contrary to the intent and plain meaning of the constitutional home-equity lending provision.

After oral argument, the Supreme Court requested that the parties submit supplemental briefing addressing the issue of whether it has jurisdiction following ACORN's withdrawal as a party. Specifically, the Supreme Court is concerned that the record does not show that the individual plaintiffs can show that their home equity loan transactions involved the particular interpretations at issue, and they, therefore, lack standing to challenge the interpretations. The parties have submitted their supplemental briefing and are waiting for the Supreme Court to rule on the jurisdictional question and issue an opinion in the case.

ACORN Suit Challenging Home Equity Interpretations
(Continued from Page 2)

This is a significant case for home equity purposes and potentially significant for all lenders, but a lot of it will depend on how broad or narrow a decision the justices issue. Some believe the Supreme Court's decision could reshape the legal landscape for lenders, potentially creating different definitions of "interest". This is far from clear. However, the Supreme Court's request for briefing on standing may signal it will ultimately decide it does not have standing and leave the important questions at issue in this case unanswered.

SOPA and PIPA: What Was All the Fuss About?

By: Ronald L, Chichester
Law Office of Ronald Chichester, P.C.

As you may have noticed, several prominent websites (Wikipedia, Boing Boing, and many other) went "black" earlier this month in protest of certain legislation pending in the U.S. Congress. The two pieces of legislation are the Stop Online Piracy Act ("***SOPA***") H.R. 3261 and the very similar but more tailored Protect Intellectual Property Act ("***PIPA***") S. 968. Both of the bills are promoted by the music and movie industries and some other large content providers.

The scene of this battle is the Internet. Specifically, the characteristics of the Internet that make global distribution of perfect digital copies nearly costless, and how that characteristic is impinging on the business models of some content providers. A side debate ensues regarding whether the Internet is actually hurting those content providers (who are making record profits), or whether those content providers are simply too slow and reluctant to accept new realities (as they have in the past). Nevertheless, some content providers have chosen to try to "put the genie back in the bottle" and regain complete control over the distribution of content that they have obtained. SOPA and PIPA are merely the latest salvos in that ongoing battle.

The provisions of SOPA and PIPA that are deemed onerous by its opponents are that that are directed to the fundamental infrastructure of the Internet, and the great potential for adverse consequences. The World Wide Web operates using a technology called the Domain Name System ("***DNS***"). DNS is the technology that translates http://www.google.com (that humans understand) into http://209.85.229.104 (that the Internet's routers understand). Both SOPA and PIPA would impose a duty on those organizations that run their own DNS servers (which includes large law firms, companies, state and local government agencies and many others) to blacklist sites identified by court order. Many of these companies do not like the idea of being held responsible for the policing of some other company's business model. Worse, the proposed legislation – as written – is vague and ripe for abuse. Consequently, companies large and small, as well as many civil groups and prominent individuals are opposing SOPA and PIPA. These protests have been remarkably successful. At the moment, both SOPA and PIPA appear stalled because of the protests. However, the companies that lobbied for the bills have promised to revive the issue in the future.

There is a good paper on SOPA and PIPA that explains in detail why those pieces of legislation are potentially harmful to the Internet and e-commerce. The paper is entitled "Don't Break the Internet" by Mark A. Lemley (Stanford Law School), David S. Levine (Elon University School of Law; Stanford University – Center for Internet and Society), & David G. Post (Temple University School of Law). The article was published in the Stanford Law Review Online, Vol. 64, p. 34, December 2011. Here is the Abstract:

Two bills now pending in Congress – the "Protect IP Act" ("***Protect IP***") in the Senate, the "Stop Online Piracy Act" ("***SOPA***") in the House – represent the latest legislative attempts to address online copyright and trademark infringement. Although the bills differ in certain respects, they share an underlying approach and an enforcement philosophy that pose grave constitutional problems and that could have potentially disastrous consequences for the stability and security of the Internet's addressing system, for the principle of interconnectivity that has helped drive the Internet's extraordinary growth, and for free expression.

E-Commerce Committee

Chair:
Ronald L. Chichester

Description:
The E-Commerce Committee monitors developments and issues relating to e-commerce, with particular attention to Texas specific issues. Such issues include proposed and new state and federal legislation (i.e. UCITA, UETA, E-Signatures), Privacy, Internet Taxes, and recent E-Commerce cases.

Get Involved:

If you would like to join the E-Commerce Committee please contact Ron Chichester at complaw@gmail.com.

Non-Competition Agreements after Marsh USA Inc., *et al*. v. Cook

By: David R. Keyes
Partner, Kelly Hart & Hallman LLP

In *Marsh USA Inc., et al. v. Cook*, the Texas Supreme Court revisited what constitutes proper consideration for a non-competition agreement. Texas courts have long considered only certain forms of consideration, such as specialized training or confidential information, as valid for non-competition agreements. This stems from the Texas Supreme Court's decision seventeen years ago in *Light v. Centel Cellular Co. of Texas*. In that decision, the Supreme Court held that the consideration for the non-competition agreement must "give rise to the employer's interest in restraining the employee from competing." In *Marsh USA*, the Texas Supreme Court abandoned this rule, providing employers with substantially more flexibility in obtaining enforceable non-competition agreements with employees.

The employee at issue in *Marsh USA* was a managing director at Marsh USA ("Marsh"), a subsidiary of Marsh & McLennan Companies ("MMC"). In 1996, the employee was offered the option to purchase 500 shares of MMC stock pursuant to MMC's 1992 Incentive and Stock Award Plan. Pursuant to the terms of the MMC Plan, the option was to vest in 25% increments each year, thereby becoming fully vested within four years. The MMC Plan required employees wanting to exercise a stock option to, among other things, execute a Non-Solicitation Agreement. In 2005, the employee desired to exercise the stock option granted in 1996 and now fully vested. As a result, the employee executed a Non-Solicitation Agreement. The Non-Solicitation Agreement contained a non-competition agreement providing that the employee would not compete for a two-year period in the event that the employee left within three years of exercising the option. The Non-Solicitation Agreement also contained a promise that the employee would keep MMC's confidential information and trade secrets confidential.

Less than three years later, the employee resigned from Marsh and was employed by a direct competitor of MMC. As a result, MMC filed suit against the employee and his new employer based, in part, on the employee's breach of the non-competition provisions contained in the Non-Solicitation Agreement. The defendants responded by moving for summary judgment asserting that the non-competition agreement was unenforceable. The trial court held that the non-competition agreement was unenforceable and the appellate court affirmed.

The Court began by noting that the agreement was governed by Texas's Covenants Not to Compete Act (the "Act"). The Court then went on to discuss the policy considerations underlying the Act, and summed up the purpose of the Act as follows:

> The Legislature . . . crafted the Act to prohibit naked restrictions on employee mobility that impede competition while allowing employers and employees to agree to reasonable restrictions on mobility that are ancillary to or part of a valid contract having a primary purpose that is unrelated to restraining competition between the parties.

As a result, the Act provides that naked restraints on competition—that is, non-competition agreements whose sole purpose is to restrain competition— are unlawful. The Court explained that this prohibition on naked restraints of trade provides "the basis for the requirement that the covenant be ancillary to a valid contract or transaction having a primary purpose that is unrelated to restraining competition between the parties." The Court then explained that it employs a two step analysis in analyzing this requirement: "First, we determine whether there is an 'otherwise enforceable agreement' between the parties, then we determine whether the covenant is 'ancillary to or part of' that agreement."

The Court then traced the history of Texas non-compete law. For many years, Texas courts enforced reasonable non-competition agreements. In Justin Belt Co. v. Yost, 502 S.W.2d 681 (Tex. 1973), the Court "articulated for the first time the common law requirement recognized by courts of appeals in Texas and other states that a covenant not to compete must be 'ancillary' to another contract, transaction or relationship." In Hill v. Mobile Auto Trim, 725 S.W.2d 168 (Tex. 1987), the Court limited the enforceability of non-competition agreements by holding that the an employee could not be restrained from accepting a job that shares a "common calling" with their current employer. The Texas courts had historically enforced reasonable non-competition clauses. This led to the passage of the Act, which was intended to reverse the Court's apparent antipathy to covenants not to compete and specifically to remove the obstacle to their use presented by the narrow "common calling" test instituted by Hill, and to "restore over 30 years of common law developed by Texas Courts and remove an impairment to economic development in the state."

The Act was passed while the landmark case of DeSantis v. Wackenhut Corp., 793 S.W.2d 670 (Tex. 1990), was pending. In DeSantis, the Court interpreted the reinstitution of prior common law to require that non-competition agreements must be "part of and subsidiary to an otherwise valid transaction or relationship which gives rise to an interest worthy of protection."

The Court observed that none of the parties in Marsh contested that an "otherwise enforceable agreement" existed. Accordingly, the Court turned to analyze whether the covenant not to compete was "ancillary to or part of" that agreement.

In Light v. Centel Cellular Co. of Texas, the Court established a two-prong test for evaluating whether a covenant was "ancillary to or part of" an otherwise enforceable agreement. This test required:

> (1) [T]he consideration given by the employer in the otherwise enforceable agreement must give rise to the employer's interest in re-

Non-Competition Agreements after Marsh USA Inc., *et al*. v. Cook

> straining the employee from competing; and (2) the covenant must be designed to enforce the employee's consideration or return promise in the otherwise enforceable agreement.

The Court stated that it intended to reexamine the "give rise" requirement contained in Light's two-prong test. The Court observed that the "give rise" requirement is not contained in the Act, but was first articulated by the Court in DeSantis. In DeSantis, the "give rise" requirement was defined as requiring that the agreement "must give rise to an interest worthy of protection." In Light, the "give rise" requirement was redefined to require that the agreement must "give rise to the employer's interest in restraining the employee from competing."

The Court found that Light's alteration of the "give rise" requirement "was more restrictive than the common law rule the Legislature intended to resurrect" in the Act. The Court noted that Light largely precluded other protectable business interests, such as goodwill, from supporting a valid non-competition agreement. As a result, it has been largely viewed that only a promise not to disclose trade secrets or confidential information would satisfy the Light "give rise" requirement.

The Court pointed out that the Act did not contain a "give rise" requirement, but simply required that the non-competition agreement must be "ancillary" to the otherwise enforceable agreement. The Act provides as follows:

> Notwithstanding section 15.05 of this code, and subject to any applicable provision of Subsection (b), a covenant not to compete is enforceable if it is ancillary to or part of an otherwise enforceable agreement at the time the agreement is made to the extent that it contains limitations as to time, geographical area, and scope of activity to be restrained that are reasonable and do not impose a greater restraint than is necessary to protect the goodwill or other business interest of the promisee.

The Court found that the term "ancillary" should simply be given its ordinary meaning, rather than the highly restrictive and narrow meaning imposed by the test in Light:

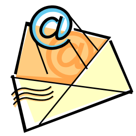
Turning to the "give rise" question, the Legislature did not include a requirement in the Act that the consideration for the noncompete must give rise to the interest in restraining competition with the employer. Instead, the Legislature required a nexus—that the noncompete be "ancillary to" or "part of" the otherwise enforceable agreement between the parties. Tex. Bus. & Com. Code § 15.50(a). There is nothing in the statute indicating that "ancillary" or "part" should mean anything other than their common definitions. "[A]ncillary means 'supplementary' and part means 'one of several . . . units of which something is composed.'" Sheshunoff, 209 S.W.3d at 541, 665 (Wainwright, J., concurring) (quoting Webster's Ninth New Collegiate Dictionary 84, 857 (9th ed.1990)).

With this rejection of Light's "give rise" requirement, the Court turned to analyze the enforceability of the non-competition agreement in Marsh. The Court found that the stock option agreement aligned the employer's interest with the interest of the employee. By providing ownership to the employee, the employee now had an interest in protecting the company's goodwill. The non-competition agreement, in turn, sought to protect the company's goodwill by fostering long-term employer-client relationships. The Court found that this goodwill was an interest worthy of protection, noting that the Act itself provides that goodwill is a protectable interest. Accordingly, the Court found that the non-competition agreement was "ancillary to or part of" an otherwise enforceable agreement and remanded the case to the appellate court for consideration of other challenges to the agreement.

What does Marsh mean for employers? It provides substantially more flexibility in entering into non-competition agreements with employees. As noted above, the only agreements that were seen as valid "ancillary" agreements were agreements to not disclose trade secrets or confidential information. Employers now potentially have the ability to negotiate and enter into non-competition provisions in connection with a variety of other types of agreements. Stock option agreements are certainly one such type of agreement. To the extent that other types of agreements serve to protect the goodwill of the company or some other protectable interest, the holding in Marsh may allow employers more flexibility to include non-competition provisions in such agreements.

Newsletter Submissions

If you would like to submit an article for inclusion in the Business Law Section's Newsletter, please email it to our Newsletter Committee Chair, Shanna Nugent, at snugent@slnlegal.com or Vice Chair, Wendy Curtis, at wcurtis@akingump.com. The Newsletter Committee reserves the right to edit contributions for clarity and content.



Keeping Your Email Address Updated

With the electronic distribution of the newsletter, it will be important for every Section member to keep an updated email address with the State Bar of Texas since that agency will distribute the email on behalf of the Section. You may update your email address at the MyBarPage of the State Bar's website. Please note that the Section will not sell or distribute your email address to anyone, including the State Bar's CLE Division.

Texas Private Equity and Venture Capital Firms – Most "Mid-Sized Advisers" Must File With the SEC by March 30

By Kevin Boardman
Partner, Patton Boggs LLP

Overview

During the last several years, managers of private equity and venture capital funds have been forced to address significantly increased regulation on the heels of the global financial crisis. In particular, changes implemented by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) and the Securities and Exchange Commission (SEC) through its rulemaking authority now require many private fund managers to register as investment advisers with the SEC, unless an exemption from registration is available.

The Dodd-Frank Act repealed the so-called "private adviser" exemption under the Investment Advisers Act of 1940 (Advisers Act), which had provided an exemption from SEC registration for investment advisers who, among other things, had fewer than 15 clients. This exemption had traditionally been relied upon by most advisers to private investment funds, as rules promulgated under the Advisers Act generally allow such advisers to count each fund that they advise as a single client, without looking through to the fund's investors. As such, many private fund managers (including managers of private equity funds, venture capital funds, mezzanine funds, hedge funds, certain real estate funds and other private investment funds) who have previously avoided registration in reliance on this exemption are now required to register with the SEC unless another exemption from registration is available.

The Dodd-Frank Act and related SEC rulemaking established several new exemptions and exclusions from the registration and reporting requirements for private fund managers, including an exemption from registration for advisers solely to private funds with less than $150 million in assets under management (Private Fund Exemption), and an exemption from registration for advisers solely to venture capital funds (VC exemption). The changes also established new reporting requirements for private fund advisers that are currently required to register with the SEC, as well as "exempt reporting advisers" – advisers who are relying on the Private Fund Exemption or VC Exemption and thus are not required to register with the SEC.

Mid-Sized Advisers Generally

The Dodd-Frank Act also effectively raised the assets under management threshold for investment adviser registration with the SEC from $25 million to $100 million, creating a new class of "mid-sized advisers" – those advisers with assets under management between $25 million and $100 million. A mid-sized adviser is prohibited from registering with the SEC unless it is either:

- not required to register as an investment adviser with the state regulator in the state where it maintains its principal office and place of business; or
- not subject to examinations as an investment adviser by the state where it maintains its principal office and place of business.

Stated differently, a mid-sized adviser <u>*must*</u> register with the SEC if it meets either of these two criteria, unless it is otherwise able to avail itself of an exemption from registration, such as the Private Fund Exemption or VC Exemption.

Texas Mid-Sized Advisers

Many private equity and venture capital fund managers based in Texas who are mid-sized advisers have reached the conclusion that because they have under $100 million of assets under management, they are not subject to SEC regulation. However, the first criteria listed above is problematic in Texas. Typical private equity and venture capital fund managers with a principal office or place of business in Texas are in fact generally <u>*not*</u> required to register as investment advisers with the Texas State Securities Board, in reliance on Rule 109.6 under the Texas Securities Act.

Texas Private Equity and Venture Capital Firms – Most "Mid-Sized Advisers" Must File With the SEC by March 30 (*Continued from Page 6*)

Rule 109.6 provides certain exemptions from state-level registration of investment advisers with the Texas State Securities Board, including persons who render investment advisory services to certain institutional investors, including:

- accredited investors (as defined in Rule 501(a)(1)-(3), (7) and (8) of Regulation D, as promulgated by the SEC under the Securities Act of 1933, as amended);
- qualified institutional buyers, or "QIBs" (as defined in Rule 144A under the Securities Act of 1933); and
- corporations, partnerships, trusts, estates or other entities (excluding individuals) having a net worth of at least $5 million.

Most mid-sized private equity and venture capital funds will satisfy one or more of the criteria listed above, including in particular Rule 501(a)(8), which refers to an entity in which all of the equity owners are accredited investors. Rule 109.6 goes on to carve out from the exemption an investment adviser to a "private fund." However, a "private fund" is defined specifically in Rule 109.6 as an entity that, among other things, permits investors who are natural persons to redeem their interests in the fund within two years of purchasing them. Unlike hedge funds which permit periodic redemptions, private equity and venture capital funds generally do not permit investor redemptions. As a result, the "typical" mid-sized Texas-based manager of a private equity or venture capital fund is not a "private fund" as defined in Rule 109.6, falls within the exemption provided in Rule 109.6 and is not required to register in Texas.

Exempt Reporting Advisers

As a result of Rule 109.6 under the Texas Securities Act, the initial criteria for mid-sized advisers being subject to a $100 million threshold for SEC registration is not satisfied. Instead, the effective threshold for SEC registration remains $25 million for most mid-sized advisers to private equity and venture capital funds having their principal office and place of business in Texas. Such mid-sized advisers will be required to register with the SEC unless they fall under another exemption. The two exemptions which most private equity and venture capital fund managers will be able to consider are the Private Fund Exemption and the VC Exemption. The Private Fund Exemption, as discussed above, covers a fund manager that advises solely "private funds" (as that term is defined by the SEC, not the Texas rules) and having aggregate assets under management of less than $150 million. The VC Exemption is highly technical and a discussion of the requirements for satisfying the exemption is beyond the scope of this article. As mentioned above, however, any private fund manager that relies on the Private Fund Exemp-

CLE Credit:

Don't miss the Business Law Section sponsored CLE's listed on the back cover!

FINRA

By: Brent Benoit
Partner, Locke Lord Bissell & Liddell LLP.

The Financial Industry Regulatory Authority ("FINRA") is the self-regulatory organization charged with regulatory oversight of broker-dealers and their associated persons. As part of its regulatory oversight activities, FINRA initiates investigations and commences enforcement actions for violations of FINRA rules, SEC regulations, or other statutory provisions, as it deems appropriate. 15 U.S.C. §78s(h)(3). These disciplinary proceedings can result in monetary and non-monetary sanctions against the subject member firm or associated person.

Recently, the Second Circuit dealt a blow to FINRA's enforcement efforts by holding that FINRA does not have the authority to seek court enforcement of monetary sanctions awards. *Fiero v. Financial Indus. Regulatory Auth., Inc.*, 660 F.3d 569 (2nd Cir. 2011). Fiero Brothers was a FINRA member firm in New York with John J. Fiero as its sole registered representative. *Id*. at 572. For reasons not disclosed in the opinion, on February 6, 1998, FINRA's predecessor, the National Association of Securities Dealers, initiated disciplinary proceedings against the firm and its registered representative. *Id*. On December 6, 2000, the hearing panel determined that Fiero Brothers and Mr. Fiero had violated the securities laws and various FINRA rules of conduct. The hearing panel, among other things, assessed a $1,000,000 fine. *Id*.

Fiero Brothers and Mr. Fiero refused to pay the fine and FINRA filed suit in the New York Supreme Court to enforce and collect the fine. *Id*. Relying on contract principles, the court concluded that FINRA could seek enforcement of the award since Fiero Brothers and Mr. Fiero had agreed to abide by FINRA rules, including those permitting the imposition of sanctions for violations. *Id*. Accordingly, the court awarded FINRA a judgment of $1,329,724.54. The judgment was upheld by the First Department of the New York Appellate Division. *Id*. at 573. The New York Court of Appeals reversed the judgment for lack of subject matter jurisdiction because FINRA's lawsuit sought "to enforce a liability or duty created under the Exchange Act, and therefore fell within the exclusive jurisdiction of the federal courts pursuant to 15 U.S.C. §78aa." *Id*.

On February 8, 2008, immediately following the New York Court of Appeals decision, Fiero Brothers and Mr. Fiero filed a declaratory judgment action in the United States District Court for the Southern District of New York. *Id*. The lawsuit alleged that FINRA lacked authority to enforce the fines it assessed in the courts. *Id*. The district court granted FINRA's motion to dismiss the lawsuit, and the matter was appealed to the Second Circuit. *Id*.

At the Second Circuit, FINRA asserted two grounds for its authority to seek judicial enforcement of fee awards: (1) the Exchange Act and (2) a FINRA 1990 rule change that was submitted to the SEC. *Id*. at 574. The Second Circuit held that neither provided a valid basis for seeking judicial enforcement of a fee award.

As to the Exchange Act, the Second Circuit acknowledged that it permitted FINRA to assess fines, but noted that "there is no express statutory authority for [FINRA] to bring judicial actions to enforce the collection of fines." *Id*. The Court noted that Congress had expressly granted the SEC the express authority to seek judicial enforcement of its penalties. *Id.*at 574-75 (citing 15 U.S.C. §78u(d)). The Second Circuit found the express grant of such authority to the SEC, but not to FINRA, to be "significant evidence that Congress did not intend to authorize FINRA to seek judicial enforcement to collect its disciplinary fines." *Id*. at 575.

The Court also noted that certain statutory provisions supported its holding that FINRA lacked authority to seek judicial enforcement of fines. The Court observed that FINRA awards are appealable to the SEC and then to the United States Court of Appeals. *Id.* The Court stated that "[h]ad Congress intended judicial enforcement, it would surely have provided for some specific relief other than leaving [FINRA] to common-law proceedings in state court or in federal district courts under diversity jurisdiction." *Id*. The Court also noted that the federal courts were provided with exclusive jurisdiction to enforce the Exchange Act. *Id*. at 576. The Court held that FINRA's contention that it could seek judicial enforcement of its fines in state courts could undermine that exclusive jurisdiction and "bristle with Exchange Act issues because the most serious fines levied by FINRA will be for member violations of the Act." *Id*.

FINRA (*Continued from Page 8)*

The Court also observed that its holding would not cripple FINRA's enforcement efforts. The Court observed that FINRA maintained a "draconian sanction" to aid its enforcement efforts. *Id*. Specifically, the Court noted that "[w]hen a member fails to pay a fine levied by FINRA, FINRA can revoke the member's registration, resulting in exclusion from the industry." *Id.* The Court also pointed out that the SEC could also initiate its own proceedings where the conduct involved a violation of the Exchange Act. *Id*. The Court also noted that FINRA's predecessor, the National Association of Securities Dealers, had longed relied on its power to revoke a member's registration to enforce its fines and enforcement decisions. *Id* The Court held that FINRA's longstanding reliance on non-judicial methods of enforcing its awards supported the Court's conclusion that FINRA lacked statutory authority to seek judicial enforcement. *Id*. at 576-77.

FINRA also argued that its judicial enforcement efforts were supported by a proposed 1990 rule change that was not disapproved by the SEC. That rule change provided that FINRA could seek judicial enforcement of its sanctions orders. *See* Self -Regulatory Organizations: Notice of Filing and Immediate Effectiveness of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to the Collection of Fines and Costs in Disciplinary Proceedings, Exchange Act Release No. 28227, 46 SEC Docket 1049 (July 18, 1990), 1990 WL 320480.

The Court held that the rule change was not properly adopted. *Id*. at 578-79. In an apparent effort to avoid the requirements of public notice and comment and SEC approval, the NASD has designated the rule change as a "house-keeping" rule. *Id*. at 579. The Court concluded, especially in light of the NASD's longstanding practice to enforce fines through non-judicial means, that the proposed rule change was not a "house-keeping" rule and had to proceed through the normal notice, comment, and approval process to become effective. *Id*. at 579. The Court found that the proposed rule change "was a new substantive rule that affected the rights of barred and suspended members to stay out of the industry and not pay the fines imposed on them in prior disciplinary proceedings." *Id.*

Because FINRA lacked authority to institute a judicial enforcement action, the Second Circuit reversed the district court's dismissal of the declaratory judgment. This ruling is a significant one for counsel representing broker-dealers and/or their registered representatives. For industry participants who desire to continue in the securities industry, FINRA retains its "draconian" sanction of a ban from the industry to compel payment of fines levied in a disciplinary proceeding. But, for participants who do not want to proceed in the industry, the opinion provides them with the opportunity to refuse to pay the fines.

It should be noted that it is not certain that a member firm or registered representative can escape the obligation to pay any fines. For example, the SEC retains its ability to bring its own actions to enforce the federal securities laws. Moreover, industry participants must carefully weigh the consequences of committing to exit the industry to avoid the payment of fines.

Law of Lawyers Committee Report—Consumer Financial Protection Bureau Demands Access to Privileged Information (Continued form Page 1)

In the Bulletin, the Bureau states that it understands the importance of the issue that a covered entity may be waiving the privilege by providing privileged information to the Bureau. However, the Bureau states that providing privileged information to the Bureau pursuant to a supervisory request would not waive any privilege that may attach to such information. Further, the Bureau went on to state that if a covered entity were ever faced with a claim of waiver, the Bureau would take all reasonable and appropriate actions to rebut such a claim. To read the Bulletin and learn more about the Bureau's rationale, go to http://www.consumerfinance.gov/wp-content/uploads/2012/01/GC_bulletin_12-01.pdf.

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Bankruptcy-Remote Special Purpose Entities: A Case and Trial to Watch

By David R. Keyes

Partner, Kelly Hart & Hallman, LLP

Doctors Hospital of Hyde Park, Inc. v. Desnick (*In re Doctors Hospital of Hyde Park, Inc.*), 360 B.R. 787 (Bkrtcy. N.D. Ill. 2007) ["**2007 Bankruptcy Decision**"], *aff'd*, 406 B.R. 299 (N.D. Ill. 2009) [**"District Court Decision"**], *vacated and remanded sub nom. Paloian vs. LaSalle Bank, N.A.*, 619 F.3d 688 (7th Cir. 2010) ["**7th Circuit Decision**"], *Mem. Op. on Paloian's Motion for Sum. J.* (*In re Doctors Hospital of Hyde Park, Inc.*), 2011 WL 6019336 (Bkrtcy., N.D. Ill., Dec. 2, 2011) ["**2011 Bankruptcy Decision**"]. These cases are referred to collectively as "***Paloian v. LaSalle Bank***".

The Customary SPE Transaction:

Parties to so-called "structured finance" or "asset securitization" transactions often create a special-purpose entity (often called a "SPE") to hold financial assets and to issue debt or equity interests directly or indirectly to lenders or investors. The SPE is required by the transaction documents and its organizational documents to be a passive entity that is not permitted to engage in other business activities. It is also required to act in accordance with corporate (or other organizational) formalities and to maintain a separate existence from its parent (or other affiliated) company (the "Company") that originated the financial assets. The Company's transfer of assets to the SPE needs to be an absolute transfer, such as by a "true sale" or "true contribution", and not in a secured loan transaction. In this context, the Company is commonly referred to as a "transferor" or "originator" of the assets. The SPE is considered to be bankruptcy-remote because of the limited nature of its passive activities, and often because the vote of one or more independent directors or managers is required for the filing of avoluntary bankruptcy proceeding. In the typical transaction, accounts receivable or other financial assets are contributed or sold to the SPE and thus are no longer owned by the Company. The purpose of this arrangement is to allow the lenders or investors to rely on the SPE's portfolio of assets without having them becoming mixed up in a possible bankruptcy proceeding of the Company. In theory, the Company, indirectly through the SPE, gets the benefit of financing on more favorable terms, because of the higher credit rating of the SPE. . For this happy result, it is necessary that there have been a "true sale" or "true contribution" of the financial assets to the SPE, that the SPE actually exist, and that the SPE would not become "substantively consolidated" with the Company in a bankruptcy of the Company. That is, the SPE and its assets would be regarded as separate from the Company and the Company's assets.

It is customary in a financing transaction involving a SPE for a law firm (ordinarily, the law firm representing the Company) to issue a "true sale and substantive consolidation" legal opinion letter. It is often a long and reasoned one and is based on various assumptions, including that the the SPE will maintain a separate existence from the Company as required by the transaction and SPE governing documents.

What happens when a court is not convinced that the financial assets have truly been transferred to a validly existing SPE that is, in substance as well as in form, separate from the Company? Welcome to *Paloian v. LaSalle Bank*. Bankruptcy remote entities are not mentioned in the Bankruptcy Code or, to this author's knowledge, in any statute, and are most often discussed in legal literature or commentary, in written guidelines of credit rating agencies, and in opinion letters, and are only rarely discussed in judicial opinions—especially by a court as high as a federal court of appeals. Thus, this case merits especial attention.

Paloian v. LaSalle Bank: **The 7th Circuit Decision Places the Separateness of SPEs in Doubt:**

Facts of the Case

LaSalle Bank, N.A., as trustee for a securitized pool of commercial loans ("LaSalle"), received lease payments from Doctor's Hospital of Hyde Park, Inc. (the "Hospital") during a period of several years before the Hospital filed a Chapter XI bankruptcy proceeding on April 17, 2000. Gus A. Paloian, as the bankrupt-

Bankruptcy-Remote Special Purpose Entities: A Case and Trial to Watch

(*Continued from Page 10*)

cy trustee (the "Bankruptcy Trustee"), sought to recover the payments as fraudulent transfers under Section 548 of the Bankruptcy Code (i.e., as payments made while insolvent and not for reasonably equivalent value). The Bankruptcy Trustee also sought recovery under the comparable, fraudulent conveyance provisions of an Illinois fraudulent conveyance statute and under Section 544 of the Bankruptcy Code. The outcome of the case depends on whether the loan repayments were made from property of the Hospital while it was insolvent (in which case they could be fraudulent transfers) or from property of MMA Funding, LLC ("MMA Funding"), a bankruptcy remote special purpose entity being the SPE in this case. MMA Funding was a subsidiary 99% owned by the Hospital and 1% owned by an entity entirely owned and controlled by Dr. James Desnick ("Desnick"), who was also the sole owner and director of the Hospital.

The 2007 Bankruptcy Decision found that the payments in question were not avoidable as fraudulent transfers because they were not made from assets of the Hospital but instead from assets of its SPE. The District Court Decision affirmed all findings of fact and conclusions of law. However, the 7th Circuit Decision vacated the District Court Decision with instructions to remand to the bankruptcy court for further findings of fact as to whether the Hospital were insolvent at the time of any payments and, if so, whether there had been a bona fide sale of accounts receivable to the SPE, and "that issue further involves the question of whether MMA Funding was in fact an actual business entity and not a part, department, or function of the [Hospital]."

In 1997, Desnick and the Hospital raised cash through two sources. On March 31, 1997 the Hospital securitized its receivables by transferring all of its current and future accounts receivable to the SPE. , The SPE paid for the receivables by borrowing under a $25mm revolving line of credit from Daiwa Healthco—2, LLC ("Daiwa"), secured by the SPE's accounts receivable acquired from the Hospital and due from patients and healthcare insurers (the "Daiwa Loan"). The parties to the Daiwa Loan transaction indicated in their documents that the SPE was intended to be a special purpose vehicle that would protect Daiwa from the possibility of a bankruptcy of the Hospital. The Hospital transferred its receivables to the SPE, which used a portion of the collections from those receivables to repay the Daiwa Loan advances over a three-year period beginning in March, 1997. Under the securitization, the Hospital indirectly received proceeds of the Daiwa Loan and used those loan proceeds to pay operating expenses. Shortly thereafter, on August 28, 1997, Nomura Asset Capital Corporation ("Nomura") loaned $50 million to another Desnick-owned and controlled entity, HPCH, LLC ("HPCH"), which owned the Hospital's building and land (the "Nomura Loan"). In connection with this transaction, HPCH increased the Hospital's rent to an amount above the fair rental value so that the rental income would equal the amount of HPCH's debt service on the Nomura Loan. HPCH pledged the lease and rent to Nomura, as well as the Hospital's 99% equity interest in in the SPE. The Hospital also guaranteed the Nomura Loan. All the proceeds of the Nomura Loan went into a bank account of Desnick and his spouse. The Hospital received none of the Nomura Loan proceeds. Subsequently, the Nomura Loan was assigned to the securitized pool of loans for which LaSalle Bank acted as the trustee. Due to the complex, cumbersome and inefficient manner in which the loan documents required cash flows to be handled, including collections of receivables and rental payments through a series of lockboxes and bank accounts, almost a year transpired before the Hospital and the SPE arranged for the cash flow to be handled in accordance with the procedures specified by the documents.

Court Analyses and Holdings

The 7th Circuit Decision focused on the period after July 7, 1998, when, pursuant to cash collateral and intercreditor agreements between Daiwa and Nomura, proceeds of the SPE's receivables were used to make payments on both the Daiwa Loan and the Nomura Loan. The Court of Appeals remanded the case for factual findings on the Hospital's solvency after July 7, 1998 and, if it were insolvent, whether the funds paid by the SPE were from its own assets or, in substance, from assets of the Hospital.

In the 2007 Bankruptcy Decision and the District Court Decision the courts declined to find that the SPE (as argued by the Bankruptcy Trustee) was a "classic shell company", but rather found that it served as a bankruptcy-remote entity that isolated the financial assets of the SPE and thereby protected the lender from the bankruptcy risk of the operating company. In concluding that MMA Funding should not be treated as the alter ego of the Hospital, the findings of the lower courts included:

Daiwa relied on the separateness of the SPE and on a legal opinion letter to the effect that the SPE would not be substantively consolidated with the Hospital in a bankruptcy proceeding.

The use of common officers and directors does not itself render a corporation liable for the obligations of another.

Even though the SPE had no officers or employees, filed no tax returns and had no assets other than the assets contributed to it by the Hospital, the SPE still functioned as a special purpose entity limited to receiving and pledging the receivables as collateral.

The Daiwa loan and the receivables were reflected in the Hospital's audited, consolidated financial statements, which did not reflect internal transfers between the Hospital and the SPE.

Bankruptcy-Remote Special Purpose Entities: A Case and Trial to Watch

(*Continued from Page 11*)

No balance sheets or profit-and-loss statements were prepared for the SPE, except a balance sheet prepared at the time of the closing of the Daiwa loan.

The SPE had no active checking account, no insurance and no phone.

The Court of Appeals was not persuaded by the separateness arguments adopted by the lower courts and stated at 695-96:

> The idea behind a bankruptcy-remote vehicle is that, if a debtor sells particular assets to a separate corporation, the lender can rely on those assets without the complications (such as preference-recovery actions) that attend bankruptcy. . . . Bankruptcy-remote entities are among several devices that borrowers and lenders have adopted to make corporate reorganization more a matter of contract and less a matter of judicial discretion. . . . .
>
> To make the idea work, the separate entity must be, well, separate. It must buy assets (here, accounts receivable). It must manage those assets in its own interest rather than the debtor's. It must observe corporate formalities, to prevent the court from rolling it back into the debtor . . . .
>
> * * *
>
> As far as we can tell from this record, however, MMA Funding lacked the usual attributes of a bankruptcy-remote vehicle. It was not independent of Desnick or the Hospital; Desnick owned MMA Funding (99% of which was owned by the Hospital, and 1% of which was owned by a firm that Desnick owned directly or through some trusts), and MMA Funding operated as though it were a department of the Hospital. It did not have an office, a phone number, a checking account, or stationery. It did not prepare financial statements or file tax returns. It did not purchase the receivables for any price (at least, if it did, the record does not show what that price was). Instead of buying the receivables at the outset, MMA Funding took a small cut of the proceeds every month to cover its (tiny) costs of operation. The Hospital continued to carry the accounts receivable on its own books, as a corporate asset; it told other creditors that Daiwa had a security interest in the receivables . . . . [Footnote added]
>
> There is scarcely any evidence in this record that MMA Funding even *existed*, except as a name that Daiwa's and Desnick's lawyers put in some documents. Daiwa can't complain; it knew that MMA Funding was a shell or could have found out easily enough. . . . But a trustee in bankruptcy can step into the shoes of any hypothetical lien creditor, see 11 U.S.C. § 544—which for current purposes may mean a creditor ignorant of the contracts signed by the Hospital, Daiwa, Nomura, LaSalle Bank, and MMA Funding. If a hypothetical creditor could have obtained an interest in assets that the Hospital's books declared belonged to it, then a bankruptcy trustee can maintain an avoidance action. . . .
>
> Perhaps LaSalle Bank can offer on remand evidence to show that there was a bona fide sale of accounts receivable from the Hospital to MMA Funding . . . and that MMA Funding was more than a name without a business entity to go with it. Or perhaps the Bank could contend that the hypothetical lien creditor must be charged with knowledge of those aspects of the earlier transactions that were matters of public record. . . But the first task on remand will be to determine whether the Hospital was insolvent at any time before filing for bankruptcy. Unless it was, nothing else matters.

On remand, the 2011 Bankruptcy Decision refused to grant the Bankruptcy Trustee's motion for partial summary judgment seeking to void the payments made by the Hospital. The motion had sought to establish that facts already in the record demonstrated that the SPE was not operationally distinct from the Hospital and that there had not been a true sale of assets from the Hospital to the SPE. Because the 7th Circuit Decision did not specify any factors that would be dispositive of the remanded issues, the 2011 Bankruptcy Decision held that such issues remain to be determined by a trial based on all available evidence.

The Bankruptcy Court Discusses Bankruptcy Remote Entities in Its 2011 Bankruptcy Decision:

The interested reader should read the 2011 Bankruptcy Decision's Parts IV.A., pp. 15-18 ("What is a Bankruptcy Remote Entity?") and IV.B. ("What is a 'True Sale'?"), pp. 18-20. The court states that there appears to exist no authoritative precedent for bankruptcy remote entities. The courts that accept their existence rely on commentary and literature as to their characteristics. "Most commentary on these entities discuss[es] the legal structure and not operational activity required to achieve and retain bankruptcy separateness." Among the articles quoted by the court, one is Comm. Bankr. & Corp. Reorganization of Ass'n Bar of N.Y.C., *Structured Financing Techniques*, 50 Bus. Law. 527, 528-29 (1995). This article states the general requirements as being, first, that there be a "true sale" of assets to the special purpose entity (such that the transferor retains no legal or equitable interest in the transferred assets), and second, the activities and relationship of the special purpose entity with the transferor

Bankruptcy-remote special purpose entities: A case and trial to watch (*Continued from Page 12)*

should be structured so that the special purpose entity's assets do not appear to be among the transferor's assets and therefore relied upon by creditors in the event of the transferor's bankruptcy.

The bankruptcy court, again citing commentators, then searched for the "usual attributes" of a special purpose entity that the 7th Circuit Decision found lacking. The court quoted at length at pp. 16-17 from one commentator who specifically addressed this case: "Debora Hoehne, *Has Bankruptcy Remoteness Become, Well, More Remote in the Seventh Circuit?*, Bankruptcy Blog, http://business-finance-restructuring.weil.com". The author notes that special purpose entities do not often send out correspondence and so do not need stationery, but that they should maintain separate bank accounts which may not have been done in this case. The author also notes that special purpose entities are often part of a consolidated group for tax and accounting purposes and so may not have separate financial statements, but the record is not clear whether MMA Funding was consolidated in this manner. The author also notes that the transferor of a financial asset may hold equity in the transferee and not always receive the purchase price in cash. The bankruptcy court, in referring to the author's observations, noted that the 7th Circuit Decision did not clarify whether or not a cash purchase is required to find that a special purpose entity is separate from the transferor.

The bankruptcy court's review of the commentary on this case stated that the above author and others have opined that the 7th Circuit Decision did not clearly involve substantive consolidation—an equitable doctrine used in bankruptcy proceedings to pool assets and liabilities of two or more companies or other persons. Although the Court of Appeals did not use the term "substantive consolidation," it used reasoning and factors often cited in determining whether corporate entities should be substantively consolidated, including compliance with corporate formalities, separateness of decision making and operations (including offices and financial statements), possession of assets, and the entities' acting at arm's length in their dealings.

Citing another source, the bankruptcy court noted how special purpose entities can be "bankruptcy proofed", including by corporate formalities, separate books and records, separate financial statements, avoiding commingling of assets, acting in its own corporate name through its own officers and agents, conducting only arm-length transactions with affiliates, and limiting the purpose and activities of the special purpose entity (which limits the creditors to those in the particular transaction). The bankruptcy court, citing Professor Thomas Plank, observed that the limitation of purpose and activities could support a finding that MMA Funding was a distinct entity despite having no function other than owning the Hospital's receivables. However, the bankruptcy court, again citing Professor Plank, noted a trend of precedent to disregard the express form of a transaction when the substance of a transaction does not match that form. He argues that the courts are correct to collapse a sale transaction when the seller retains all the risks and benefits of the transferred assets, but that the transaction should be viewed differently when the risks and benefits are transferred such that the sold assets become isolated from the transferor's other creditors.

Nevertheless, the bankruptcy court acknowledged that the law of this case on remand is as set out by the 7th Circuit Decision—that there is a broader standard of operational independence requiring detailed evidence yet to be produced, in order to show that MMA Funding had a "distinct set of operations." Significantly, the bankruptcy court posed the issue of whether, if MMA Funding existed as a separate entity at its inception, it ever ceased to exist. The bankruptcy court then moved to the next issue—if MMA Funding did exist, was there a "true sale" of the receivables from the Hospital to MMA Funding?

Some Commentary on the Effects of *Paloian v. LaSalle Bank*:

Professor Dan Schechter offers criticism of *Paloian v. LaSalle Bank*. In his view, it is hard to imagine what additional evidence the parties might have been able to produce showing true "operational separateness" between the Hospital and MMA Funding, such that the transaction could ever qualify for bankruptcy-remote status. He concludes, "If this BRE [bankruptcy-remote entity] did not pass muster, many others will be similarly vulnerable." As to the potential consequences of this case, he writes:

> If a valid BRE depends upon a showing of "true operational separateness" then attorneys arranging asset securitizations will have to set up elaborate procedures for each BRE, under which the BRE will hire its own employees, maintain its own offices, use its own secretary, etc., all in an effort to provide window dressing for the transaction. This careful charade will increase the upfront costs of each deal. Worse yet, one can expect that bankruptcy trustees (and debtors in possession) will continue to challenge the factual 'separateness' of these BRE structures; the increased risk of litigation will have to be priced into the asset securitization. And if that 'separateness' cannot be established on summary judgment, the costs (and risks) of each such lawsuit will be even greater.

Some Questions after *Paloian v. LaSalle Bank*:

Bankruptcy-remote special purpose entities: A case and trial to watch (*Continued from Page 13*)

We are left with a number of interesting questions regarding the after-effects of *Paloian v. LaSalle Bank* on asset transfers to bankruptcy-remote, special purpose entities:

Independence of Ownership

1. How much independence between the transferor and the special purpose entity is required? It is common for the special purpose entity to be owned entirely or mostly by the transferor or its affiliates. Is more separateness and independence required of a special purpose entity whose bankruptcy-remote character is to be recognized?

Substantive Consolidation

2. Is *Paloian v. LaSalle Bank* really a substantive consolidation case? Although the 7th Circuit Decision never mentions the bankruptcy doctrine of substantive consolidation, should the case be read as an adoption or expansion of the so-called Auto-Train substantive consolidation test to determine whether the benefits of treating entities as separate outweigh the economic prejudice of consolidation? *In re Auto-Train Corp.*, 810 F.2d 270 (D.C. Cir. 1987).

Substance over Form

3. Will a special purpose entity, even though it is created in the customary way under structured finance documentation and follows all corporate formalities, be disregarded for lack of economic substance, i.e., where there is no substantive business being carried on by the special purpose entity?

Independence of Operations

4. Is it fair to say that prior to *Paloian v. LaSalle Bank* generally the separateness of a special purpose entity was established if it had the requisite *legal* independence, as compared to maintaining both legal and *operational* independence?

5. Will the new test created in the 7th Circuit Decision requiring *operational* independence between the transferor and its special purpose entity, in addition to *legal* independence, be adopted or rejected by courts in other federal circuits?

6. What types of operations would a passive, limited-purpose entity solely holding ownership of financial assets need to conduct in order to meet an operational independence test?

7. Even if a special purpose entity were properly created at the outset, under what circumstances would it lose its status and be deemed to have ceased to exist if it ceased complying with the separateness requirements of the documents? Areas of importance might include not only the continued observance of corporate formalities, but also the handling of funds, financial reports and other operational matters.

8. In the case of a truly passive entity having common ownership and common officer's and directors with a transferor of financial assets, is there any practical circumstance in which the entity could meet the Seventh Circuit's operational independence test? Would having one independent director (who votes only on a decision to file bankruptcy and perhaps on a limited number of other extraordinary events) be enough?

True Sale and Applicable Law

9. Even if a transfer is regarded as a true sale under applicable state law, will a bankruptcy court apply federal law as the basis for its determination of economic substance and of the independence of the transferee?

Paloian v. LaSalle Bank as *Precedent*

10. To what extent will this case's arguments and holdings spread to other federal circuits?

11. How will legal opinion letters regarding true sales and substantive consolidation deal with this case?

12. If this case were to end with the Hospital's being found to have been solvent at the time of the payments in question, will the part of the 7th Circuit Decision that discusses bankruptcy remote entities become dicta and lose its effect as binding precedent?

Bankruptcy-remote special purpose entities: A case and trial to watch (*Continued from Page 14)*

13. Might this case ultimately be distinguished from other cases based on its unique facts, including the Court of Appeal's possibly negative view of Desnick, who owned and controlled the Hospital, the SPE, and other affiliates involved in the facts?

We may not find out the answers to some or all of these questions within *Paloian v. LaSalle Bank* itself if the case settles or if the bankruptcy court after trial finds that the Hospital was solvent at the time of the payments (thus mooting the issue of whose property was used for the payments).

Stay tuned.

What Happened to Article 9 in 2011

By Jacqueline S. Akins

Chapter 9 of the Texas Business and Commerce Code (Article 9 of the Uniform Commercial Code [UCC]) governs secured transactions. The National Conference of Commissioners on Uniform State Laws (NCCUSL) made significant changes to Article 9 (commonly referred to as Revised Article 9 or R9) in 1998 which Texas enacted in 1999, with a uniform effective date of July 1, 2001. The Commissioners have met over the intervening years to address issues and questions that have arisen since the initial revisions were made most notably in the area of debtor names and filing changes for the International Association of Commercial Administrators (IACA). The latest set of revisions was approved by the American Law Institute and the Uniform Law Commission (the UCC's sponsoring organizations) and presented at the American Bar Association in July, 2010 resulting in a recommendation for enactment of the Commission's changes to the uniform act. The changes are primarily minor adjustments to language although it also addresses issues related to individual debtor names and trust records. In some instances, currently existing Texas non-uniform revisions have been retained.

SECTION BY SECTION DESCRIPTION OF CHANGES

Section 9.102 made changes to the definitions of "authenticate", "certificate of title", "jurisdiction of organization" and "registered organization". It also added a new definition "public organic record".

"Authenticate" was amended to track the language of the Uniform Electronic Transactions Act and E-SIGN, to reflect changes in technology in adopting or accepting a record, and to be consistent with the definition of "sign" in revisions to Article 1 and Revised Article 7.

The changes to "certificate of title" allow for other types of records in addition to certificates of title if the State's statute permits notation of the security interest on the record as a condition of perfection. It allows for electronic records created as an alternative to issuance of paper title certificates. It also clarifies that state statutes that require notation of the security interest on the title for perfection and those that allow for perfection when delivery is made to the issuing agency both fit this definition.

"Jurisdiction of organization" was revised to add "formed" to the definition.

What Happened to Article 9 in 2011 (*Continued from Page 15)*

The changes to "registered organization" were made to reflect the addition of the public organic record definition. A registered organization is basically one that takes some type of public record filing to form it or complete its formation. A general partnership is not considered a registered organization because it doesn't require the filing or issuance of a record by a State or the United States to create it. On the other hand, a corporation, limited liability company, or limited partnership usually require a filing or issuance of some type of document by a governmental entity and so are considered registered organizations. These changes will now pick up a statutory trust formed under state law by filing with the secretary of state's office and a common law trust formed for a business purpose that is required by a state's business trust statute to file a record with the state.

The definition of "public organic record" was added to clarify which public record is the correct source for determining the debtor's name. In addition to documents or records such as articles of incorporation, it includes organizations created by legislation and government charters that form organizations (a record available for public inspection and is initially filed with or issued by a State or the United States to form or organize an organization and any amendments amending or restating the initial record if filed or issued by the State or United States or a record initially filed with the State and any amendments to it if the statute of the State governing business trusts requires such a filing or a legislation enacted by a legislature of a State or Congress, any record of amending legislation, and any record filed or issued by a State or United States that amends or restates the name of an organization).

All of these are NCCUSL changes.

Section 9.105 (Control of Electronic Chattel Paper) is amended by adding subsection (a) to recognize the storage and transfer of such documentation by means of a system while retaining the previous broad standards for recognition of control of these assets. It is a general test for what constitutes control. Subsection (b) establishes a safe harbor that meets the requirements of (a).

This is a NCCUSL change which was made in recognition of the increase in electronic commerce and documentation and the fact that electronic chattel paper "cannot be transferred, assigned, or possessed in the same manner as tangible chattel paper".

Section 9.307(f)(2) (Location of Debtor) was changed to clarify the ability of a registered organization to designate its main, home or comparable office as its location if applicable federal law permits.

This is a NCCUSL change.

Section 9.311 was revised to remove the listing of specific state statutes concerning certificates of title in 9.311(a)(2) and substitute broader descriptive language. The revision is designed to address the change in the definition of certificate of title and accommodate any future central filing or other non-notation perfection statutes that may be adopted. The statutes listed currently are Chapter 501, Transportation Code, relating to the certificates of title for motor vehicles; Subchapter B-1, Chapter 31, Parks and Wildlife Code, relating to the certificates of title for vessels

What Happened to Article 9 in 2011 (*Continued from Page 16)*

and outboard motors; Chapter 1201, Occupations Code, relating to the documents of title for manufactured homes; and Chapter 261, relating to utility security instruments.

This is a non-uniform change but in an area left to the states by the drafters.

The title of **Section 9.316** was changed to more accurately describe its contents which deal with continued perfection of a security interest. It adds a subsection to provide rules to address the continuation of a security interest when a debtor changes location to another jurisdiction. It also adds a subsection for rules when a financing statement is filed as to the original debtor and the new debtor is located in another jurisdiction.

Debtors move or change their locations from time to time. While security and other agreements require debtors to tell their secured lenders about these changes, this does not always happen immediately. The section allows the secured creditor's interest in after-acquired property, if properly perfected, to remain perfected in the new jurisdiction until the original filing expires or four months from the date of the move, whichever happens first. This allows a secured creditor to discover this change and make the necessary re-filings to continue its security interest. Prior to this amendment, there was no grace period for the perfection of any security interest attaching to the debtor's post-change of location after-acquired property.

In addition to moving and changing locations, debtors may change their names as well. If the security interest was properly perfected in after-acquired property as to the original debtor and the new debtor acquires rights in the collateral (by acquiring the assets of the original debtor for example) before it becomes bound by the original security agreement or within four months of becoming bound by the original security agreement, the security interest in the post-merger after-acquired property remains perfected as to the new debtor until the original filing expires or four months from the date of the move, whichever happens first.

Note these changes regarding post-merger after-acquired property in interstate mergers should be read in conjunction with the changes to 9.326 and also 9.508 for competing security interests in the old and new debtor where the security interest is perfected only by financing statements.

These are NCCUSL changes.

Section 9.317(d) is modified to substitute "collateral" for the previous list of collateral that a licensee of a general intangible or a buyer other than the secured party may take free of a security interest if the licensee or buyer gives value without knowledge of the security interest and before it is perfected.

This is a NCCUSL change.

The wording of **Section 9.326** is revised to deal with some priority contest issues that come about when the new debtor becomes bound by an existing security agreement of the original debtor and both the new and original debtor have secured creditors.

What Happened to Article 9 in 2011 (*Continued from Page 17*)

Language is added to subsection (a) clarify existing language and add sections applicable to perfect the security interest where the financing statement would otherwise be ineffective. It was done to reconcile sections 9.508 and the new 9.316(i)(1).

For example, Lender A has filed a financing statement perfecting a security interest in X Corporation's existing and after-acquired inventory. Lender B holds a perfected by possession security interest in a particular item of Corporation Z's inventory. Both debtors are located in the same state. Z buys X's assets and assumes X's security agreements as part of the purchase agreement. Because A's continued priority depends on Section 9.508, this change makes A's security interest subordinate to B's. In short, if a secured party has to depend on either 9.508 or 9.316(i)(1) to preempt another secured party's interest, then 9.326 overrides these and allows the secured party's interest that does not depend on these two sections to prevail.

This is a NCCUSL change.

Normally the UCC encourages free transferability of assets and does not favor restrictions on assignments, transfers, and creation of security interests. Prior to this amendment, this free transferability concept did not apply to the sale of payment intangibles or promissory notes. **Section 9.406(e)** is amended to exempt a sale of payment intangibles or promissory notes used as collateral after a debtor defaults or when the creditor accepts this collateral in full or partial settlement of an obligation from the types of sales which are restricted by agreements between account debtors and assignors or in promissory notes that prohibit, restrict, or require consent of certain parties to transfers of these types of collateral. This allows the secured party to dispose of the collateral without regard to these restrictions in the event of the debtor's default.

This is a NCCUSL change.

This section also adds a non-uniform subsection (k) to address a recent case allowing a debtor to assign lottery winnings free and clear of child support obligations under Chapter 466, Section 466.410 of the Government Code. This non-uniform change will allow such obligations to take precedence over the free assignability provisions of Chapter 9.

The changes to **Section 9.408(b)** are similar to the changes made to 9.406 in that it clarifies default rights. 9.408(a) has the same concept of free transferability for health care insurance receivables and general intangibles such as contracts, permits, licenses, and franchises. Prior to the amendment, (b) applied to a security interest in a payment intangible or promissory note only if the security interest arose out of a sale of the collateral. The change to (b) carves out a sale of payment intangibles or promissory notes used as collateral after default by a debtor or when accepted by the creditor in full or partial settlement of an obligation from the types of sales which are from the "only if" language that existed prior to the amendment. This means the secured party will look back to 9.406 for default rights in this type of collateral.

What Happened to Article 9 in 2011 (*Continued from Page 18*)

This is a NCCUSL change.

Section 9.502 is amended by revising the wording stating a mortgage does not have to indicate the record will be filed in the real property records. It adds subsection (c)(3)(B) due to the adoption of Alternate A to Section 9.503 to define when a record sufficiently provides the name of an individual debtor in order to avoid a conflict with that alternative.

These are NCCUSL changes.

There are a number of changes to **9.503** to address various debtor name issues.

Registered Organizations - If a debtor is a registered organization, including a trust that is a registered organization, the financing statement should provide the name that is stated to be that of the registered organization according to the most recently filed with or issued by the jurisdiction under which the registered organization is formed. Estates - If collateral is being administered by an estate representative, the financing statement must provide the name of the debtor and state in a separate section of the financing statement that the collateral is being administered by a personal representative.

Trusts (not registered organizations) - For trusts that are not registered organizations, a financing statement must provide as the debtor's name, the name specified as the name of the trust in its organic record. If the organic record does not specify a name for the trust, the name of the settlor or testator and either that the collateral is held in a trust or additional information sufficient to distinguish the trust from other trusts having one or more of the same settlors or testator and indicate the collateral is held in a trust.

Individuals – Several courts have struggled with the question of what is the individual debtor's name. The uniform version of R9 simply stated that the name of the debtor should be used "without further rule or guidance as to what constitutes the debtor's name". States that had adopted the uniform version have case law that holds the use of the debtor's nickname rather than his legal name to be ineffective [Morris v. Snap-on Credit, LLC (In re Jones), 2006 WL 3590097 (Bankr.D.Kan. Dec. 7, 2006)], the lack of a letter in a name as causing the financing statement to be ineffective [Hopkins v. NMTC, Inc. (In re Fuell), 2007 WL 4404643 (Bankr.D. Idaho Dec. 13, 2007), and Pankratz Implement Co. v. Citizens Nat'l Bank, 130 P.3d 57 (Kan. 2006)] and most recently, the use of the name the debtor had used since establishing his banking relationship in

STATE BAR OF TEXAS

ANNUAL MEETING

June 14-15

George R. Brown Convention Center

Hilton Americas

The Business Law Section and the Corporate Counsel Section will cosponsor a two day CLE at the Convention. Please Come Join Us.

The Business Law Section will hold its annual meeting at the conclusion of the CLE presentations on Thursday June 14th.

What Happened to Article 9 in 2011 (*Continued from Page 19*)

1995 rather than the name on his birth certificate as being misleading [Miller v. State Bank of Arthur, 2012 Bankr. LEXIS 70 (Bankr.C.D.Il 2012)]. This led Texas to adopt its non-uniform provision driver's license or identification certificate provision effective 2007 and lead the drive for additional clarity in this area.

The first level of appropriate name for the financing statement is that on an unexpired Texas driver's license or identification card. If none of this documentation is available, the financing statement would reflect the individual name of the debtor or the surname and first personal name of the debtor. Additional forms of acceptable identification were offered in the original bill but were ultimately deleted.

A provision defining what is a sufficient record to determine the name of a decedent, dealing with multiple driver's licenses or identification cards, and determining the name of a settlor or testator have also been added.

These are basically NCCUSL changes.

Section 9.507 was amended to make minor language changes providing more clarity and guidance as to changes in the name of the debtor. If the name change causes the name of the debtor on the filed financing statement to become seriously misleading, the secured party has four months to file an amended financing statement. Property acquired by the debtor during the grace period will be subject to the security interest. This is a NCCUSL change.

Section **9.515(f)** changes add the word "initial" so if a debtor is a transmitting utility, the *initial* financing statement rather than a filed financing statement must provide it is effective until termination.

This is a NCCUSL change.

Texas' non-uniform Section **9.516** is amended by changing "correction statement" to "information statement" to accord with changed NCCUSL terminology.

Texas' non-uniform Section **9.518** is revised to change "correction statement" to "information statement" in accordance with amended NCCUSL terminology.

Section **9.607(b)(2)(A)** is amended to add language to ensure that if the collateral consists of a note secured by a mortgage, the secured party may enforce the mortgage in the event of the maker of the note's default. The prior language just says a "default has occurred". It is not clear, under the prior language whether the referenced default applied to the debtor or the maker of the note. The revised language addresses this point. This is a NCCUSL change. However, a secured party with this type of collateral should take into account the current posture on enforcement of mortgages and requirements and litigation around assignments of notes and liens in seeking to utilize this provision.

Effective Date - The transition provisions provide the changes will take effect on July 1, 2013 and address financing statements filed and other action taken prior to that date, security interests unperfected prior to that date, amendment of pre-effective date financing statements, and resolution of conflicting priority claims.

What Happened to Article 9 in 2011 (*Continued from Page 20)*

Conforming definitions for Article 2A are also added.

Report of Nominating Committee

As provided in Article IV, Section 1 of the Bylaws of the Business Law Section of the State Bar of Texas, the current Chair of the Section, David E. Harrell, appointed Roger Bartlett, Gail Merel and Brad L. Whitlock to serve as the Nominating Committee for members of the Council of the Section to be elected at its annual meeting in 2012. Mr. Harrell asked Mr. Whitlock to serve as Chair of the Nominating Committee.

The members of the Committee met via telephone conference call and communicated via electronic messages. The Nominating Committee is pleased to make and report the following nominations for two-year terms on the Section's Council, to serve commencing immediately following the close of the Section's 2012 annual meeting:

Gregory R. Samuel
David R. Keyes
F. John Podvin, Jr.
E. Steve Bolden II
Irene Kosturakis

Additionally, the Committee nominates Cheryl Tangen for election to fill the unexpired one-year term of Mr. Harrell.

The other five members of the Council elected for two-year terms in 2011 will continue to serve, and Mr. Harrell will also serve as a member of the Council as its immediate past Chair as provided in Article II, Section 2 of the Bylaws of the Section.

The Committee also recommends that the Council, at its annual meeting following the annual meeting of the Section, elect the following individuals as officers of the Section, to serve commencing at the close of the Council's annual meeting:

Gregory R. Samuel, Chair
David R. Keyes, Chair-Elect
Ronald L. Chichester, Vice-Chair
Ryan R. Cox, Secretary-Treasurer

Pro-Bono Committee Report

LAWYERS' COMMITTEE FOR CIVIL RIGHTS UNDER LAW

A nonprofit, nonpartisan legal organization formed at the request of President Kennedy in 1963

ELECTION PROTECTION YOU HAVE THE RIGHT TO VOTE

1-866-OUR-VOTE ▪ www.866OurVote.org

Pro Bono Opportunities

The Lawyers' Committee for Civil Rights Under Law, along with our coalition partners, seeks pro bono law firms, lawyers, law students and paralegals to volunteer for Election Protection 2012.

<u>What is Election Protection:</u> Election Protection (EP) – led by the Lawyers' Committee - is the nation's largest **non-partisan** voter protection coalition. The national voter hotline (1-866-OUR-VOTE) and our Election Day field program assists voters with problems and guides them through the voting process. In addition, EP provides critical legal resources throughout the year, including for early voting, voter registration, working with election officials and supporting grassroots organizations. Election Protection is a resource for all Americans.

<u>Pro Bono Assistance Needed:</u> Legal volunteers are needed now through Election Day 2012 for a variety of tasks. Involvement may be as minimal as volunteering for a four hour voter hotline shift or providing leadership throughout the year in key localities. Training and guidance are provided to all volunteers. Voting rights materials are available for all locations.

- **Leadership – serve on Legal Committees in key cities** with other volunteers to lead local EP efforts, including identifying and responding to voting rights issues as they arise, working with election officials, and managing field programs. (Winter 2012 through Election Day)
- **Legal Materials – update state legal voting rights materials.** (Winter/Spring 2012)
- **Voter Hotline and Field Program** – Lawyers, paralegals and law students needed to staff the 1-866-OUR-VOTE hotline, volunteer for Election Day field program and respond to problems with early voting in specific states. (October-Election Day)

<u>Where:</u> Election Protection will have call centers and field programs in over 20 states.

<u>Additional Information or to Volunteer:</u> Please contact Nancy Anderson, Director of Pro Bono, at 202-662-8354 or nanderson@lawyerscommittee.org. For additional information on Election Protection, visit www.electionprotection.org.

*Election Protection is a **non-partisan** effort and is not affiliated in any way with any candidate or political party.*

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UPCOMING CLE PROGRAMS

Free CLE at State Bar of Texas Annual Meeting:

George R. Brown Convention Center, Houston, Texas
June 14-15, 2012
Presented jointly by the Business Law Section and the Corporate Counsel Section
Admission is free to all members of either section
Register online for the Annual Meeting at www.texasbar.com.

Choice and Acquisition of Entities in Texas:

Hyatt Regency Hill Country Resort and Spa, San Antonio, Texas
Live: May 25, 2012 (San Antonio)
Video: June 29, 2012 (Dallas) and July 13, 2012 (Houston)
Presented by TexasBarCLE and cosponsored by the Business Law Section
Business Law Section Members received $25 off registration fees
Register online at www.texasbarcle.com

11th Annual Advanced In-House Counsel Course:

Westin Galleria Hotel, Dallas, Texas
Live: August 2-3, 2012 (Dallas); Video: September 6-7, 2012 (Houston)
Presented by TexasBarCLE and cosponsored by the Business Law Section and the Corporate Counsel Section
Business Law Section Members received $75 off registration fees
Register online at www.texasbarcle.com

Business Law Section members mix and mingle